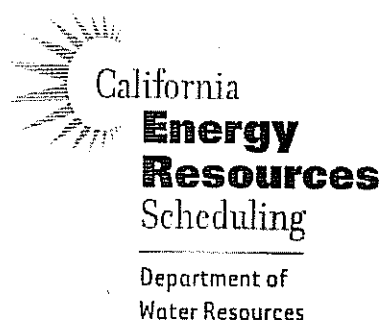


Department of Water Resources Electric Power Fund Financial Statements

December 31, 2003



Department of Water Resources Electric Power Fund

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Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

USING THIS REPORT

This discussion and analysis is designed to assist the reader in focusing on significant financial issues and activities and to identify any significant changes in financial position of the Department of Water Resources Electric Power Fund (Fund), which is administered by the California Department of Water Resources (DWR). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follows *Management's Discussion and Analysis*.

The basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of activities and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of a specified date. The statement of activities presents all of the revenues and expenses for a specified time period. The final required statement is the statement of cash flows. This statement reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities; operating activities, financing activities and investing activities. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund has adopted accounting standards promulgated by the Governmental Accounting Standards Board.

This report should be read in conjunction with the Fund's June 30, 2003 audited financial statements.

HISTORY AND FINANCING

The Fund was established in January 2001, in connection with the Governor of California's emergency proclamation and subsequent legislation to assist in mitigating the effects of a statewide energy supply emergency.

In November 2002, DWR completed the issuance of \$11.3 billion in revenue bonds. The proceeds of the bond issues, along with \$2.1 billion of cash and investments in the Fund, were used to repay the outstanding balance of a \$4.3 billion term loan from a financial consortium led by JPMorgan Chase Bank, repay \$6.2 billion in advances from the State's General Fund with interest, and establish separate accounts in the Fund as required by the Bond Indenture. The bonds are payable from Bond Charges and, if necessary, other revenues, collected over a 20 year period. DWR also entered into \$1.4 billion notional amount of interest rate swaps reducing its un-hedged variable rate exposure to approximately 25% of the initial par value of the bonds issued.

IMPLEMENTATION OF 2003 SUPPLEMENTAL REVENUE REQUIREMENT

DWR's responsibility for purchasing the "residual net short", as defined in the Bond Indenture, was transferred to the investor owned utilities on January 1, 2003. DWR was then permitted, under the terms of the Bond Indenture, to reduce both the minimum Operating Account balance and the balance in the Operating Reserve Account.

Based on 1) the ability to reduce the minimum Operating Account balance and the balance in the Operating Reserve Account, 2) the expected receipt of cash for past due amounts being held in trust by Pacific Gas & Electric Company (PG&E), and 3) increases in actual and forecasted costs, DWR developed its 2003 Supplement Revenue Requirement, reducing DWR's 2003 revenue requirement needs

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

by \$1.002 billion. The 2003 Supplement Revenue Requirement was submitted to the CPUC on July 1, 2003.

On September 4, 2003, the CPUC implemented the 2003 Supplemental Revenue Requirement and DWR transferred \$147 million from the Operating Reserve Account to the Operating Account. The past due amount from PG&E (net of the \$444 million allocable bill credit for PG&E customers) was collected on September 11, 2003, and deposited in the Operating Account. The Operating Account then had sufficient funds on hand to be able to reduce its cash balances by \$558 million through bill credits for the customers of Southern California Edison Company and San Diego Gas & Electric Company and still remain in compliance with the minimum cash balance requirements of the Bond Indenture. Processing of the bill credits was finalized during the quarter ended December 31, 2003.

STATEMENT OF NET ASSETS

The Fund's assets and liabilities as of December 31, 2003 and June 30, 2003 are summarized as follows (in millions):

	December 31, 2003	June 30, 2003
Restricted cash and investments		
Operating Account	\$ 954	\$ 1,177
Priority Contract Account	76	84
Bond Charge Collection Account	184	156
Bond Charge Payment Account	379	229
Other investments	40	37
Recoverable costs, current portion	523	1,129
Other current assets	20	36
Long-term restricted cash and investments	1,557	1,704
Recoverable costs, net of current portion	8,335	7,568
Total assets	<u>\$ 12,068</u>	<u>\$ 12,120</u>
Long-term debt, including current portion	\$ 11,614	\$ 11,636
Other current liabilities	454	484
Total capital and liabilities	<u>\$ 12,068</u>	<u>\$ 12,120</u>

Restricted Cash and Investments

The decrease in the Operating Account balance during the six months ended December 31, 2003 reflects a combination of the \$1 billion bill credit, collection of past due amounts from PG&E, and collections from the sale of more power than forecast. The increase in the Bond Charge Payment Account reflects the expected accumulation of funds needed to provide for the \$180 million principal payment due May 1, 2004. Long-term restricted cash and investments decreased by \$147 million in the Operating Reserve Account as allowed by the Bond Indenture with the end of DWR's responsibility for procurement of the "residual net short". From the dates of issuance of the revenue bonds through December 31, 2003, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the Bond Indenture.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

Recoverable Costs

The current portion of recoverable costs reflects billings to IOU customers that have not yet been collected. The current portion of recoverable costs decreased \$606 million from June 30, 2003 to December 31, 2003, primarily due to the collection of \$521 million of past due amounts owed by PG&E.

Long-term recoverable costs consist of costs that are recoverable through future billings. The \$767 million increase is primarily attributable to the aforementioned bill credit, recognizing that costs previously incurred but not billed to customers increased due to the bill credits.

Revenue Bonds

The amount of revenue bonds outstanding at December 31, 2003 and June 30, 2003 reflect the par value of the bonds issued plus unamortized premium. The first principal payment of \$180 million on the revenue bonds is scheduled for May 2004.

Accrued Interest Payable

Accrued interest payable is \$68 million at December 31, 2003 as compared to \$69 million at June 30, 2003. The two accruals are substantially the same because they are for the same length of time in relation to the November 1st and May 1st semi-annual interest payments for the fixed rate bonds.

STATEMENT OF ACTIVITIES

The Fund's activities for the three and six months ended December 31, 2003 and 2002 are summarized as follows (in millions):

	3 months ended December 31		6 months ended December 31	
	2003	2002	2003	2002
Revenues				
Power charges	\$ 1,221	\$ 1,257	\$ 1,716	\$ 2,540
Bond charges	189	52	466	52
Interest	14	14	28	30
Total revenues	<u>1,424</u>	<u>1,323</u>	<u>2,210</u>	<u>2,622</u>
Expenses:				
Power purchases	1,216	1,293	2,743	2,528
Interest expense	105	106	210	244
Other expenses	7	251	26	275
Recovery (deferral) of recoverable costs	<u>96</u>	<u>(327)</u>	<u>(769)</u>	<u>(425)</u>
Total expenses	<u>1,424</u>	<u>1,323</u>	<u>2,210</u>	<u>2,622</u>
Net Income	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

Power Charges

Power Charges decreased by \$824 million in the six months ended December 31, 2003 as compared to the comparable period in 2002. This decrease is primarily attributable to recognizing the \$1.002 billion bill credit to customers as a reduction in Power Charges, all in the first three months of the period. The majority of the remaining difference is attributable to the State's "20-20 Energy Rebate Program" which provided a reduction totaling \$90 million in certain customers' 2002 bills because they had reduced their energy use over 2000 levels.

Bond Charges

The Bond Charge was established in November 2002 to pay for debt service on the revenue bonds. Bond Charges are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to customers in each IOU's service area and certain "direct access" Electric Service Provider (ESP) customers. Bond Charges earned for the three and six months ended December 31, 2003 and 2002, are comparable to those forecast in the cash flow analyses utilized in developing the revenue bond structure. However, the amounts collected in 2002 are substantially lower because the bonds were not issued until the late 2002 and the bond charge was not implemented until November, 2002.

Power Purchases

DWR power costs were \$215 million more in the six months ended December 31, 2003, than in the same period in 2002. The amount of power purchased in the two six month periods was substantially the same. However, for the six months ended December 30, 2002, approximately 30 percent of the power was purchased on the spot market at prices that were less than the prices of power purchased under long-term contracts. For the comparable period in 2003, with the successful transfer of spot purchasing to the IOUs, all DWR power was purchased under the terms of the long-term contracts and included capacity payments for dispatchable contracts and the purchase of natural gas.

Other Expenses

Other expenses incurred during the six months ended December 31, 2003 are \$249 million less than incurred during the six months ended December 31, 2002. Other expenses in 2002 were substantially higher due to bond issuance costs, which accounted for almost all of the difference between the two years. Approximately \$14 million of the net change in the six month period ending December 31, 2003 is due to an increase in statewide "pro rata" costs assessed by the State Department of Finance for centralized services provided to DWR by other state departments.

Interest Expense

Interest expense incurred during the three and six month periods ended December 31, 2003, is \$1 million and \$34 million less than incurred during the respective three and six months ended December 31, 2002. The amounts for the three months ended December 31, 2003 and 2002 are expected to be comparable as the revenue bonds were outstanding for both time periods. The \$34 million difference for the six month period is attributable to the issuance of revenue bonds in fall 2002. The effective interest rate for the revenue bonds (4.8%) is less than the interest rate for either the General Fund advances or the term loan which were outstanding through November 2002 and had rates of 5.3% and 5.7%, respectively.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

FUTURE OPERATIONS

DWR will administer the Fund until such time as the revenue bonds are completely retired. Revenue requirements for the repayment of the bonds will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to implement Bond Charges for the customers of the IOUs and ESPs such that the Fund will always have monies to pay bond related costs, including debt service and swap payments, when due.

DWR has financial and legal responsibility for the power supply contracts, including the purchase of natural gas for some of the contracts, for the life of the contracts. DWR cannot enter into any new power supply contracts and the last of the power supply contracts expires in 2013. Revenue requirements for the payment of energy purchased under the power supply contracts will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to implement Power Charges such that the Fund will receive necessary monies to meet its revenue requirements.

Ultimately the financial responsibility for the power supply contracts may be transferred to the IOUs as part of complete assignment of the contracts and release of DWR. However, there are a number of issues to be addressed, including IOU creditworthiness and counterparty approval, before the contracts can be assigned.

Department of Water Resources Electric Power Fund
Statements of Net Assets
December 31, 2003 and June 30, 2003 (in millions)

	December 31, 2003	June 30, 2003
Assets		
Current assets:		
Cash and investments		
Restricted cash and investments:		
Operating Account	\$ 954	\$ 1,177
Priority Contract Account	76	84
Bond Charge Collection Account	184	156
Bond Charge Payment Account	379	229
Other investments	40	37
Recoverable costs, current portion	523	1,129
Interest receivable	14	15
Inventory - natural gas	6	-
Due from other funds	-	21
Total current assets	<u>2,176</u>	<u>2,848</u>
Long-term assets:		
Restricted cash and investments:		
Operating Reserve Account	630	777
Debt Service Reserve Account	927	927
Recoverable costs, net of current portion	<u>8,335</u>	<u>7,568</u>
Total long-term assets	<u>9,892</u>	<u>9,272</u>
Total assets	<u>\$ 12,068</u>	<u>\$ 12,120</u>
Capitalization and Liabilities		
Capitalization:		
Long-term debt:		
Revenue bonds	\$ 11,392	\$ 11,414
Total capitalization	<u>11,392</u>	<u>11,414</u>
Current liabilities:		
Current portion of long-term debt	222	222
Accounts payable	386	415
Accrued interest payable	<u>68</u>	<u>69</u>
Total current liabilities	<u>676</u>	<u>706</u>
Commitments and Contingencies (Note 5)		
Total capitalization and liabilities	<u>\$ 12,068</u>	<u>\$ 12,120</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund

Statements of Activities

For the three and six months ended December 31, 2003 and 2002

(in millions)

	For 3 months ended December 31		For 6 months ended December 31	
	2003	2002	2003	2002
Operating revenues:				
Power charges (net of bill credit of \$1,002 million in quarter ended September 30, 2003)	\$ 1,221	\$ 1,257	\$ 1,716	\$ 2,540
Total operating revenues	<u>1,221</u>	<u>1,257</u>	<u>1,716</u>	<u>2,540</u>
Operating expenses:				
Power purchases	1,216	1,293	2,743	2,528
Administrative expenses	7	10	26	19
Recovery (deferral) of recoverable operating costs	<u>(2)</u>	<u>(46)</u>	<u>(1,053)</u>	<u>(7)</u>
Total operating expenses	<u>1,221</u>	<u>1,257</u>	<u>1,716</u>	<u>2,540</u>
Income from operations	-	-	-	-
Bond charges	189	52	466	52
Interest income	14	14	28	30
Costs for issuance of revenue bonds	-	(241)	-	(256)
Interest expense	(105)	(106)	(210)	(244)
Deferral (recovery) of recoverable debt service and related costs	<u>(98)</u>	<u>281</u>	<u>(284)</u>	<u>418</u>
Net income	-	-	-	-
Net assets, beginning of period	-	-	-	-
Net assets, end of period	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund**Statements of Cash Flows****For the six months ended December 31, 2003 and 2002****(in millions)**

	2003	2002
Cash flows from operating income:		
Receipts from customers:		
Power charges	\$ 2,428	\$ 2,766
Payments for power purchases and other costs	(2,794)	(2,573)
Net cash provided by (used in) operating activities	<u>(366)</u>	<u>193</u>
Cash flows from non-capital financing activities:		
Proceeds from revenue bonds, net of underwriters' fees and bond insurance premiums	-	11,437
Receipts from customers for bond charges	390	32
Payments on term loan	-	(3,849)
Payments to State of California General Fund	-	(6,620)
Interest payments	<u>(232)</u>	<u>(69)</u>
Net cash provided by non-capital financing activities	<u>158</u>	<u>931</u>
Cash flows from investing activities:		
Investments purchased	(20)	-
Interest received on investments	<u>28</u>	<u>46</u>
Net cash provided by investing activities	<u>8</u>	<u>46</u>
Net increase (decrease) in cash and investments	(200)	1,170
Unrestricted cash and investments, beginning of year	<u>3,350</u>	<u>2,119</u>
Restricted (2003) and unrestricted (2002) cash and investments, end of period	<u>\$ 3,150</u>	<u>\$ 3,289</u>
Reconciliation of operating income to net cash provided by (used in) operating activities:		
Income from operations	<u>\$ -</u>	<u>\$ -</u>
Changes in net assets and liabilities to reconcile operating income to net cash used in operations:		
Recoverable costs	(352)	239
Inventory - natural gas	(6)	-
Due from other funds	21	1
Accounts payable	<u>(29)</u>	<u>(47)</u>
Total adjustments	<u>(366)</u>	<u>193</u>
Net cash provided by (used in) operating activities	<u>\$ (366)</u>	<u>\$ 193</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund
Notes to Financial Statements
For the six months ended December 31, 2003 and 2002

1. Reporting Entity

Background

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (Fund) was established on January 19, 2001, by Senate Bill 7 from the First Extraordinary Session of 2001 (SB7X). Assembly Bill 1 from the First Extraordinary Session of 2001 (AB1X), enacted on February 1, 2001, added Division 27 to the California Water Code to clarify and expand the powers of DWR to incur debt for the purposes of the Fund and to use amounts in the Fund for the purchase of power. The Fund is administered by DWR. Division 27 of the California Water Code (as subsequently amended by Senate Bill 31 from the First Extraordinary Session of 2001) includes the following powers and requirements:

- Authorizes DWR to act on behalf of the State of California to secure necessary power supplies for resale to customers of Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E) (collectively referred to as the investor owned utilities or IOUs).
- Prohibits DWR from entering into new power purchase agreements after December 31, 2002, but allows DWR to continue to administer existing contracts and enforce revenue requirements beyond that date.
- Requires DWR to retain title to all power sold, but authorizes DWR to enter into service agreements with the IOUs for transmission, distribution, billing and collection services.
- Authorizes DWR to issue bonds payable solely from the Fund.
- Authorizes DWR and the California Public Utilities Commission (CPUC) to enter into an agreement with respect to charges to provide for recovery by DWR of its revenue requirements.
- Entitles DWR to recover its revenue requirements incurred in connection with its authorized activities, including debt service, the costs of power purchases, administrative costs and reserves.

DWR began selling electricity to approximately ten million retail customers in California in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and, through December 31, 2002, in short-term and spot market transactions. DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the CPUC. DWR initially financed its power purchases with advances from the General Fund of the State of California, loans from financial institutions, and revenues from power sales to customers. The advances from the General Fund and the remaining balance of the loans from financial institutions were repaid from the proceeds of revenue bonds issued in October and November 2002.

Department of Water Resources Electric Power Fund
Notes to Financial Statements
For the six months ended December 31, 2003 and 2002

Basis of Presentation

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenses.

Revenues and Recoverable Costs

Before the issuance of revenue bonds, the cost of energy provided by DWR and debt service was recovered through charges to the customers of the IOUs as authorized by ABIX and established by the CPUC. Revenues were recognized when energy provided by DWR was delivered to the customers. Prior to the issuance of the revenue bonds, costs were recovered through Power Charges. Since the issuance of the revenue bonds, customer charges are separated into two primary components, Power Charges and Bond Charges. Power Charge revenues recover the cost of power purchases, administrative costs and operating reserves and are recognized when energy provided by DWR is delivered to the customers. Certain customers of "direct access" Electric Service Providers (ESP) are assessed "cost responsibility surcharges" that are used by DWR for the same purposes as Power Charge revenues. Bond Charge revenues recover debt service and debt service reserves and are recognized when energy provided by either DWR or the IOU, or an ESP, is delivered to customers. Costs are recovered over a period of time as determined by DWR's revenue requirement process. Amounts that have been earned but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings are recorded as long-term.

2. Restricted Cash and Investments

Restricted cash and investments, for purposes of the statements of cash flows, includes cash on hand and amounts in short-term investments. Amounts in short-term investments consist of deposits in the State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF).

Cash not required for current use is invested in SMIF. SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). The investments in PMIA are carried at fair value, which approximates amortized cost. Generally, the investments in PMIA are available for withdrawal on demand. Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 1.55% and 1.70% at December 31, 2003 and June 30, 2003, respectively.

3. Long-Term Debt

During October and November 2003, DWR issued \$11.264 billion in revenue bonds. The proceeds from the bond issue, along with the cash balance in the Fund at the date of issuance, were used to repay previously incurred debt (General Fund advances and a term loan from a financial consortium) and fund restricted cash and investment accounts as required by the Bond Indenture.

Department of Water Resources Electric Power Fund
Notes to Financial Statements
For the six months ended December 31, 2003 and 2002

The following activity occurred in the long-term debt accounts during the six months ended December 31, 2003 (in millions):

	Revenue Bonds	Unamortized Premium	Total Revenue Bonds
Balance, June 30, 2003	\$ 11,264	\$ 372	\$ 11,636
Amortization of premium	-	(22)	(22)
Less current portion	<u>(180)</u>	<u>(42)</u>	<u>(222)</u>
Balance, December 31, 2003	<u>\$ 11,084</u>	<u>\$ 308</u>	<u>\$ 11,392</u>

The revenue bonds, all of which except Series E are tax-exempt, consist of the following at December 31, 2003:

Series	Rates	Fiscal Year of Final Maturity	Fiscal Year of First Call Date	Amounts Outstanding (in millions)
A	3.0-6.0%	2022	2012	\$ 6,314
B	Variable	2020	Callable	1,000
C	Variable	2022	Callable	2,750
D	Variable	2022	Callable	500
E	3.6-4.3%	2006	Not callable	<u>700</u>
				11,264
Plus unamortized premium				350
Less current maturities				<u>(222)</u>
				<u>\$ 11,392</u>

Series B and C have daily and weekly rate modes, respectively, and Series D has 35-day auction periods. The variable rate bonds have a final stated maturity of 2022, but will be retired in sinking fund installments from 2005 to 2022. Total interest expense and financing costs for the six months ended December 31, 2003 and 2002 for all revenue bonds was \$210 million and \$60 million, respectively. The interest rates for the variable debt for the six months ended December 31, 2003, ranged from 0.4% to 1.3%. The remaining \$184 million in interest for the six months ended December 31, 2003 related to the financings in place prior to the bond issuance.

Principal and interest payments (and other bond related costs, including swap payments) are primarily secured by bond charges. The Fund is subject to certain bond covenants, including establishing funding and expenditure requirements for several restricted cash and investment accounts. The bonds are limited special obligations of the Fund; neither the principal nor any interest thereon constitutes a

Department of Water Resources Electric Power Fund
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For the six months ended December 31, 2003 and 2002

debt of the State. The payment of principal and interest for all Series B and certain Series C bonds (\$1.75 billion out of a total Series C size of \$2.75 billion) are paid from draws made under letters of credit. In the case of these bonds, draws made under the letters of credit are to be reimbursed on the same day by the Fund. There are no outstanding amounts on the letters of credit at December 31, 2003. The letters of credit expire in 2005. The Fund pays fees of 0.85% per annum on the stated amount of the letters of credit.

The remaining \$1 billion of Series C bonds is credit enhanced by bond insurance. Liquidity support for these bonds is provided by bank liquidity facilities. Any funds paid under the bond insurance or liquidity facilities are immediately due and payable by the Fund. There are no outstanding amounts on liquidity facilities at December 31, 2003. Three liquidity facilities backing \$300 million in Series C bonds expire in 2005, and two liquidity facilities underlying \$700 million of Series C bonds expire in 2009. The Fund pays fees of between 0.22% and 0.37% per annum on the liquidity facilities.

Future payment requirements on the revenue bonds are as follows at December 31, 2003 (dollars in millions):

Fiscal Year	Principal	Interest¹	Total
2004	\$ 180	\$ 204	\$ 384
2005	388	401	789
2006	409	385	794
2007	427	368	795
2008	449	348	797
2009-2013	2,612	1,427	4,039
2014-2018	3,397	803	4,200
2019-2022	3,402	192	3,594
	<u>\$ 11,264</u>	<u>\$ 4,128</u>	<u>\$ 15,392</u>

¹ Variable portion of the interest cost calculated using the December 31, 2003
Bond Market Association Municipal Swap Index (BMA)

4. Interest Rate Swaps

DWR, on behalf of the Fund, entered into interest rate swap agreements with various counterparties, to reduce variable interest rate risk. The swaps create a synthetic fixed rate for DWR. DWR has agreed to make fixed rate payments and receive floating rate payments on notional amounts equal to a portion of the principal amount of DWR's variable rate debt.

Department of Water Resources Electric Power Fund
Notes to Financial Statements
For the six months ended December 31, 2003 and 2002

The terms, fair values, and credit ratings of counterparties for the various swap agreements are summarized in the following table (dollars in millions):

Outstanding Notional Amount at December 31, 2003	Fixed Rate Paid by Fund	Variable Rate Received by the Fund ¹	Fair Values at December 31, 2003	Swap Termination Date	Counterparty Credit Ratings (Moody's, Fitch's, S&P)
\$ 94	2.914%	80% of LIBOR ²	\$ (2)	5/1/2011	Aa, AAA, AAA
234	3.024%	80% of LIBOR	(3)	5/1/2012	Aa, AAA, AAA
200	3.405%	BMA ³	(4)	5/1/2013	Aa3, AA-, AA-
100	3.405%	BMA	(2)	5/1/2013	Aa3, AA-, A+
30	3.405%	BMA	(1)	5/1/2013	Aa3, AA-, A+
194	3.204%	80% of LIBOR	(2)	5/1/2014	Aa1, AA, AA-
174	3.280%	80% of LIBOR	(3)	5/1/2015	Aa, AAA, AAA
202	3.342%	80% of LIBOR	(2)	5/1/2016	Aa3, AA-, A+
202	3.389%	80% of LIBOR	(2)	5/1/2017	Aa3, AA-, A+
\$ 1,430			\$ (21)		

¹ LIBOR based swaps convert to pay the Fund 67% of LIBOR on January 1, 2004

² One month U.S. Dollar London Interbank Offered Rate

³ Bond Market Association Municipal Swap Index

The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions to outstanding notional amounts that follow scheduled amortization of the associated debt.

Fair Value: Because interest rates have declined, all swaps had a negative fair value as of December 31, 2003. The reported fair values from the table above were provided by the counterparties, using the par value, or marked-to-market, method.

Credit Risk: As of December 31, 2003, the Fund was not exposed to credit risk because the swaps had negative fair values. However, should interest rates increase and the fair values become positive, the Fund would be exposed to credit risk in the amount of the swaps' fair value. DWR has a total of nine swap agreements with six different counterparties. Three swaps, approximating 35 percent of the total notional value are with a single counterparty with a credit rating of Aa/AAA/AAA. Of the remaining swaps, two are held with a single counterparty, approximating 21 percent of the outstanding notional value. That counterparty has credit ratings of Aa3/AA-/A+. The remaining four swaps are with separate counterparties, all having Aa3/AA-/A+ ratings or better.

Basis Risk: The Fund is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR (a taxable rate index). The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while DWR's floating receipts on the swaps are based on LIBOR, which is determined in the

Department of Water Resources Electric Power Fund
Notes to Financial Statements
For the six months ended December 31, 2003 and 2002

taxable market. Should the relationship between LIBOR and the tax-exempt market change and move to convergence, or should DWR's bonds trade at levels worse (higher in rate) in relation to the tax-exempt market, DWR's all-in costs would increase. As of December 31, 2003, the variable rate on DWR's bonds ranged from .4% to 1.3%, while 80% of LIBOR received on the swap was equal to .9%.

Termination Risk: DWR's swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract. In addition, the swap documents allow either party to terminate in the event of a significant loss of creditworthiness by the other party. DWR views such events to be remote at this time. If a termination were to occur, at the time of the termination, DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. The counterparty would be liable for any payment equal to the swap's fair value, if it had positive fair value at that time. In addition, a termination would mean that DWR's underlying floating rate bonds would no longer be hedged, and DWR would be exposed to floating rate risk, unless it entered into a new hedge following termination.

Rollover Risk: Since the swap agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt, there is no rollover risk associated with the swap agreements, other than in the event of a termination.

Swap Payments and Associated Debt: As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of December 31, 2003, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term were as follows (in millions):

Fiscal Year Ending June 30	Variable Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	\$ -	\$ 8	\$ 17	\$ 25
2005	-	16	33	49
2006	-	16	33	49
2007	-	16	33	49
2008	-	16	33	49
2009-2013	658	76	158	892
2014-2017	772	23	48	843
Total	<u>\$ 1,430</u>	<u>\$ 171</u>	<u>\$ 355</u>	<u>\$ 1,956</u>

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5. Commitments and Contingencies

Litigation and Uncertainties

DWR is involved in several lawsuits and regulatory proceedings. In one action ("PG&E1"), PG&E contested the determination of DWR's revenue requirement submissions for calendar years 2001 and 2002. The trial court found that DWR had failed to follow the California Administrative Procedures Act (APA) and ordered DWR to do so. The trial court also ruled that its decision did not affect any prior actions taken by the CPUC, including the implementation of cost recovery of DWR's calendar years 2001 and 2002 revenue requirements. This ruling was appealed and was affirmed in part and reversed in part, on October 2, 2003, with the appellate court concluding that "AB1X does require DWR to make a determination that its revenue requirement is just and reasonable, but neither AB1X nor the APA requires a public hearing or compliance with the APA procedures." The deadline for appeal having passed and no appeal having been filed, the appellate court's decision is now final.

In August 2002, during the pendency of the appeal of PG&E1, DWR determined its 2003 revenue requirement and re-examined its 2001-2002 revenue requirements and filed them with the CPUC. In October 2002, PG&E filed a lawsuit ("PG&E2") on the 2003 revenue requirements and the re-examined 2001-2002 revenue requirements, claiming that DWR had not adequately followed APA requirements or DWR's own regulations and claiming that a portion of DWR's revenue requirements were unjust and unreasonable and therefore invalid. On December 26, 2003, the Sacramento County Superior Court issued a ruling stating that DWR failed to comply with its own regulations in making its just and reasonable determination of the 2003 revenue requirement. However, the Court also stated that its ruling "does not nullify, interfere with, or in any way affect any action that has been taken by the California Public Utilities Commission, including enforcement and collection of existing rates and charges, to implement the Department's revenue requirement." The deadline for appeal has not passed.

In another matter, two energy suppliers have petitioned the Federal Energy Regulatory Commission ("FERC"), contending that amounts totaling \$58 million are owed by DWR for power purchased in the last half of January 2001, by DWR on behalf of PG&E and SCE in the California Independent System Operator (ISO) market. DWR maintains that the Fund has remitted the appropriate payments to the ISO for distribution to the energy suppliers. The ISO distributed the Fund's January payment on a pro-rata basis to all market participants for the entire month, although DWR purchased power on behalf of the two IOUs beginning in late January. As a result, energy suppliers did not receive full payment for the amounts owed them for power purchased in January by DWR on behalf of the two IOUs. On November 25, 2002, FERC issued an order finding that the ISO had "misapplied the payment it received from CERS" and directed the ISO to "reallocate its pro-rata disbursement for the entire month of January 2001, and disburse funds from DWR allocated for January 2001, to those that supplied power for the period January 17 - 31, 2001." The ISO recently submitted a filing to FERC outlining its process of calculating the distribution of funds from DWR. On December 22, 2003, FERC issued an order upholding its prior determination that CERS' funding obligation did not commence until January 17, 2001 and that disbursements for January 2001 should be divided into periods before and after that date.

Additionally, various actions are underway contesting certain long-term power contracts entered into by DWR.

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There are a number of other lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result because of potential impacts on the price or supply of energy in California. In one case, California Power Exchange Corporation (CalPX), certain IOUs and others have brought suit against the State of California claiming that the State's commandeering of CalPX's block forward contracts after CalPX filed bankruptcy in early 2001 was unconstitutional. The plaintiffs argue that they are entitled to damages of \$1.1 billion, which is their estimation of the fair value of the block forward contracts at the time of commandeering. Under the block forward contracts, which expired in December 2001, the Fund paid approximately \$350 million for energy provided by the contracts.

These lawsuits and regulatory proceedings could impact power costs and the related revenue requirements, and the terms and conditions of the power purchase contracts.

Management believes that the existing lawsuits and regulatory proceedings will be resolved in calendar year 2004. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

Commitments

DWR has entered into power purchase contracts, some of which have remaining lives through 2013. Power purchases made under these contracts approximated \$1.2 billion and \$1.3 billion for the three months ended December 31, 2003 and 2002, respectively, and \$2.7 billion and \$2.5 billion for the six months ended December 31, 2003 and 2002, respectively.

The remaining amounts of fixed obligations under the contracts as of December 31, 2003, are as follows:

For the Year Ending June 30,	Fixed Obligation (in millions)
2004	1,783
2005	3,190
2006	2,809
2007	2,525
2008	2,378
Thereafter	5,681
	<u>\$ 18,366</u>

In addition to the fixed costs there are variable costs with several of the contracts. Management expects that the amount of fixed and variable obligations associated with long-term power purchase contracts to approximate \$30 billion as of December 31, 2003. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

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Contingencies

The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes that any costs associated with such losses are recoverable from customers as part of DWR's revenue requirement.

6. Bill Credit

Based on 1) the ability to reduce the minimum Operating Account balance and the balance in the Operating Reserve Account as allowed under the Bond Indenture, 2) the expected receipt of cash for past due amounts being held in trust by PG&E, and 3) increases in actual and forecasted costs, in July 2003 DWR decreased its 2003 revenue requirement by \$1.002 billion. On September 4, 2003, the CPUC ordered implementation of the decrease in revenue requirements through credits for DWR Power Charges in the monthly billings to IOU customers from mid September through mid October 2003. Amounts expected to be received from PG&E, net of PG&E customers' portion of the bill credit, were received on September 11, 2003. Implementation of the bill credit was finalized during the three months ended December 31, 2003.